May 19, 2020

The Honorable Jay Clayton, Chairman

U.S. Securities and Exchange Commission

100 F Street NE

Washington, DC 20549

Re: Proposed Rule on Good Faith Determinations of Fair Value (Release No. IC-33845; File No. S7-07-20 RIN 3235-AM71)

Dear Chairman Clayton:

We are writing to you to comment on the proposal to modernize framework for fund valuation practices. Our academic research looks at the valuation of venture capital-backed private companies. These companies are an increasingly important part of the economy,[1] held by not just venture capital funds but also mutual funds and private equity funds. Because of this, we believe we can contribute to the conversation.

First, we want to state that valuing these companies is fundamentally a hard problem. There is a large amount of fundamental uncertainty about the business prospects of many of these companies. The volatility of these values is high[2] and evaluating the prospects of these companies relies on considerable expertise and the evaluation of numerous soft factors.[3] Not only is evaluating the real business difficult, these companies have complicated financial structures that make valuation and across-share class comparisons of value difficult.[4]

Second, funds are doing a poor job of valuing these private venture capital-backed companies. These valuation issues occur across fund types. Conversations with the limited partners that

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[1] Gornall, W., & Strebulaev, I. A. (2015). The economic impact of venture capital: Evidence from public companies.

[2] Cochrane, J. H. (2005). The risk and return of venture capital. *Journal of Financial Economics*, *75*(1), 3-52.

[3] Gompers, P. A., Gornall, W., Kaplan, S. N., & Strebulaev, I. A. (2020). How do venture capitalists make decisions?. *Journal of Financial Economics*, *135*(1), 169-190.

[4] Gornall, Will, and Ilya A. Strebulaev. "Squaring venture capital valuations with reality." *Journal of Financial Economics* 135.1 (2020): 120-143.

provide capital to venture capital funds tell us that they do not feel they can trust the values put out by venture capital funds and that there are often significant differences between the values two funds assign to the same company. Evidence of this phenomenon is clear for mutual funds, where many funds appear to be following valuation techniques that significantly misrepresent the value of the holdings.[5] A clear example of this is The We Company, whose valuation was reported at dramatically different levels by different mutual funds.[6] Beyond these cross sectional differences, valuations tend to be overly smooth.[7] [8]

Third, the lack of appropriate valuations leads to real economic inefficiency. Valuations that are difficult to compare and not trustworthy mean that limited partners struggle to evaluate in progress funds. This makes it difficult for managers without a record of accomplishment to raise capital which leads to misallocation and other distortions.[9] It also leads to mismeasurement of risks and returns for limited partner portfolio allocation purposes. Pension funds and other investors must have accurate information on the risk and value of their holdings, something that current valuation practices appear to fail at providing. Mutual funds that hold assets with smoothed reported returns understate fund risk, which inflates risk-adjusted performance measures such as alphas and Morningstar ratings.

This is a difficult problem and we are happy to see the revisions to valuation standards. Keeping in mind that difficulty, we have two suggestions.

First, a stronger push for funds to adjust stale valuations to reflect interim market movements. If the broad stock market falls 10%, funds should mark down their investments by 10% unless there is a compelling reason not to. FAS 157 implementation appears to have improved this manner of reporting; however, more progress should be made as even in the 2010s we see

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[5] Id.
[6] https://www.morningstar.com/articles/959754/weworks-wild-valuation-ride, accessed April 22, 2020.
[7] Jenkinson, T., Sousa, M., & Stucke, R. (2013). How fair are the valuations of private equity funds?. *Available at SSRN 2229547*.
[8] Agarwal, V., Barber, B. M., Cheng, S., Hameed, A., & Yasuda, A. (2019). Private company valuations by mutual funds. *Available at SSRN 3066449*.
[9] Gompers, P. A. (1996). Grandstanding in the venture capital industry. *Journal of Financial Economics*, *42*(1), 133-156.

significant autocorrelation of venture capital returns and returns that lag broad market indices – both indicators of stale prices. Better mark to market practices will help investors better understand both where they stand and the risk of their positions.

Second, increased disclosure on valuation methods. At present use, venture capital funds and mutual funds holding private companies often provide little more than legal boilerplate about their valuation techniques and assumptions. This makes it difficult for investors to grasp the underlying reality of these companies and compare funds to each other.

The current proposal pushes toward these goals, but it may not go far enough in protecting the interests of investors and fund managers in the venture capital space.

Sincerely,

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